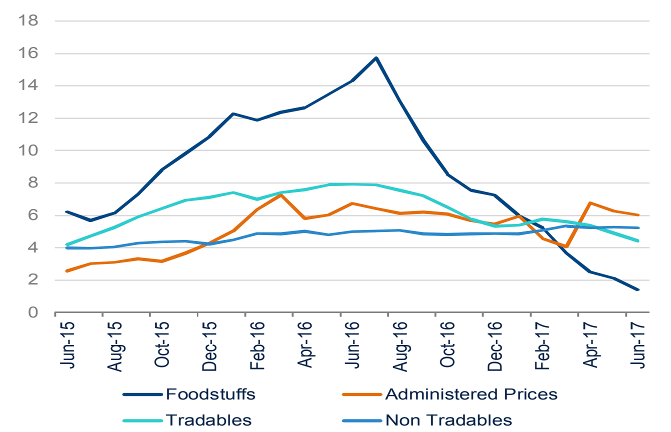
5. Inflation is falling, shaking off supply-side shocks

The supply-side shocks are being diluted, and overall inflation is slowing, whilst headline inflation remains slightly high

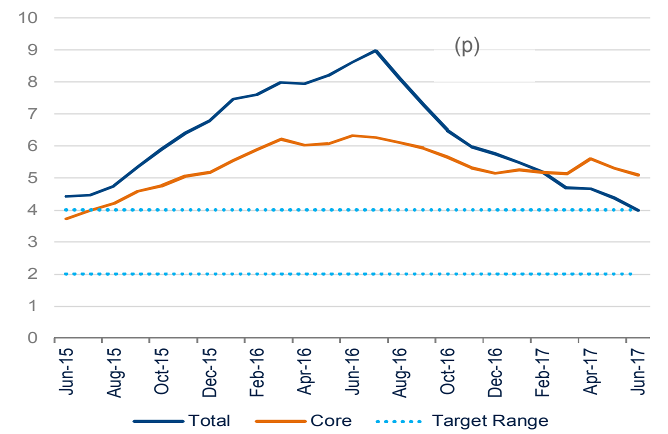
The two main shocks that increased inflation in 2015 and 2016 - the "*El Niño*" phenomenon and the depreciation of the exchange rate as a result of the shock to the terms of trade - are continuing to dilute. Normal rainfall in 2017 has resulted in food inflation correcting from 14.2% to 1.4% over the last year (Figure 5.1). In 2017, the exchange rate has fallen below its average level in 2016. This has reduced the cost of imported products, enabling the inflation rate for tradable products to slow from 7.9% to 4.4% in the last 12 months. It should be noted that this deceleration was slowed somewhat by the VAT increase at the start of the year, which mainly affected tradable products.

Figure 5.1 Inflation by product type (%)



Source: DANE

Figure 5.2 Total and headline inflation (%)



Source: DANE and BBVA Research

Although total inflation has fallen by around 500 bp since its peak last year, the Central Banks still has some concerns about the behaviour of certain prices. The most important of these involves inflation for non-tradable items, which should be slowing at a time at a time when demand is cooling. However, inflation for these items has accelerated over the year as a result of price increases for some services related to health, education and, to a lesser extent, leasing. This behaviour has avoided a sharper fall in headline inflation (Figure 5.2) and may, according to the Central Bank, represent a risk to convergence on its long-term target. However, two very different pressures may be lurking. Firstly, Colombia's economy is still facing some stubborn contributors to inflation, such as those from regulated construction and the permitted adjustment to inflation-linked rents. Secondly, it may be evidence that the slowdown in activity has also affected the potential growth rate: in this regard, the excess demand expected could be lower, despite the cut (Box 4.1). The policy response would be different in both cases: whilst the persistence of inflation should be temporary, the slowdown in inflation would help convergence, but only over a longer period. In the second case, the policy response cannot be loose, because this runs the risk of stoking inflation. This means the Central Bank would need to act cautiously, seeking out evidence that demand has in effect weakened.

Supported by the stability of the exchange rate, inflation will converge on the target range in 2018, creating room to cut rates to 4.5%

We expect the downward trend in inflation to continue in 2017 and 2018, standing at 4.3% and 3.2% at year end, respectively. Total inflation will continue to fall more rapidly than headline inflation in 2017, until June at least, with the decline in the headline rate accelerating in 2018 (Figure 5.2). Behind this trend, the exchange rate will play a key role. The currency will remain relatively stable in 2017 and 2018, at around 2980 pesos per dollar, ensuring that inflation for imported products will continue to fall. This trend will be reinforced by the weakness of demand we expect to see over these two years.

The downside surprises to activity in the first quarter (the Central Bank expected 1.3% growth), with economic activity continuing to grow at less than its potential rate in 2017 and 2018, as it did in 2016, together with the downward trend in inflation, seem to tilt the balance towards more aggressive monetary policy. However, the slow decrease in headline inflation and the behaviour of inflation for the non-tradable basket are sufficient counterweights for the Central Bank to act cautiously. Its strategy will continue to focus on reducing its policy rate, as inflation slips back, but without overstepping the line of the neutral rate, which we estimate to be a real interest rate of between 1.5% and 2.0%. The Central Bank will cut its policy rate to 5.25% in 2017 and to 4.50% in 2018. The pause in cuts is justified by the slow decline in headline inflation in 2017, which will not start to correct rapidly until the start of 2018.